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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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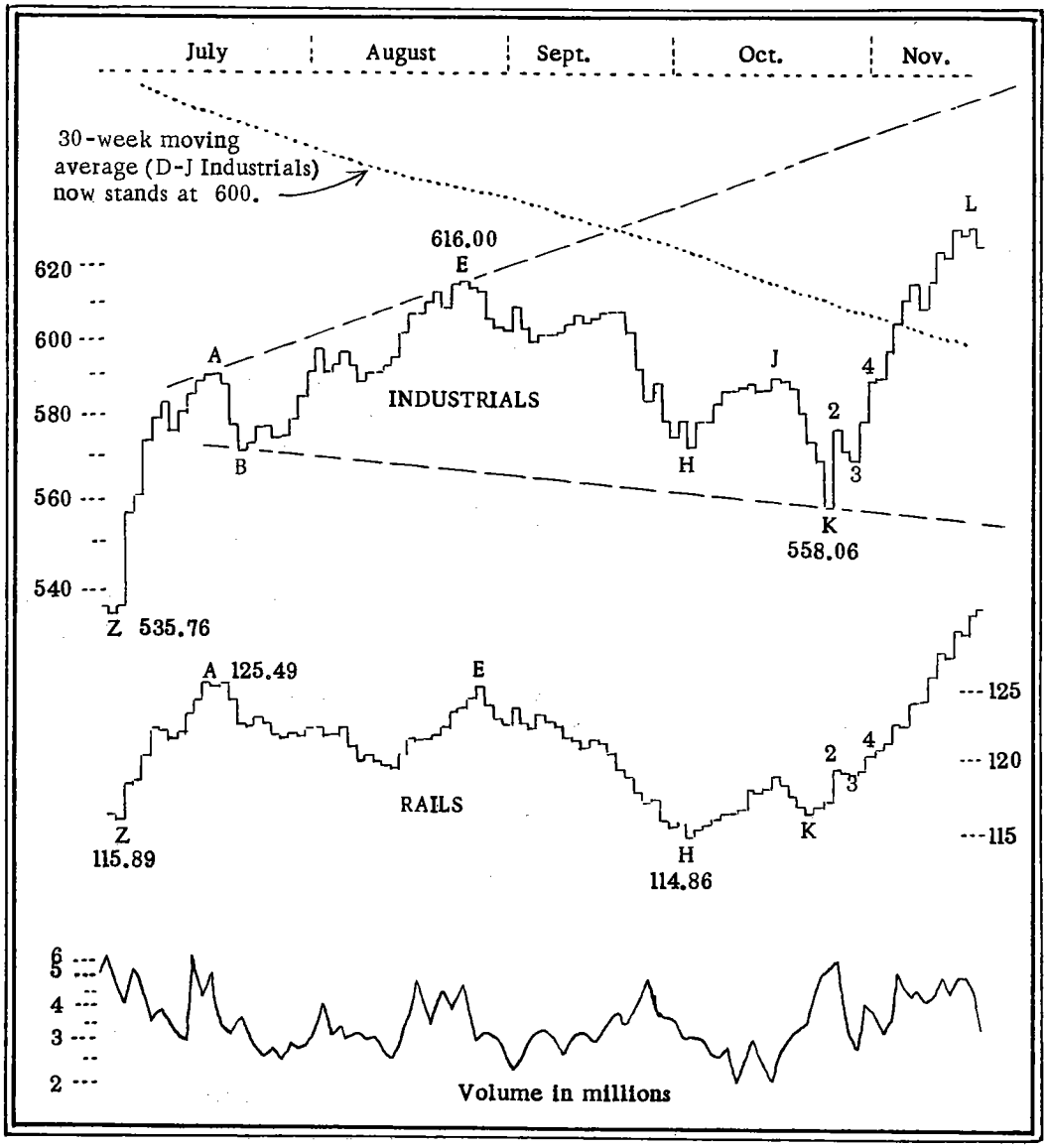
THE MARKET There is an old adage which states: "The market can do anything." It is a rather vague expression, but it undoubtedly reflects the problems faced by traders, investors, and analysts who have had to deal with Wall Street over the years. I have always felt that the above adage should be amended to read: "The market can do anything which the technical situation will allow."

The violent rise from the K (October 23) lows stemmed from the technical vacuum of a new low on the advance-decline ratio which was unconfirmed by the Industrial Average. At K Industrials could have collapsed, thereby confirming the new low on the A-D ratio, or they could have rallied in proof of their persistent desire to resist downside confirmation. The latter course was chosen (and this action is commented upon in detail later in this Letter).

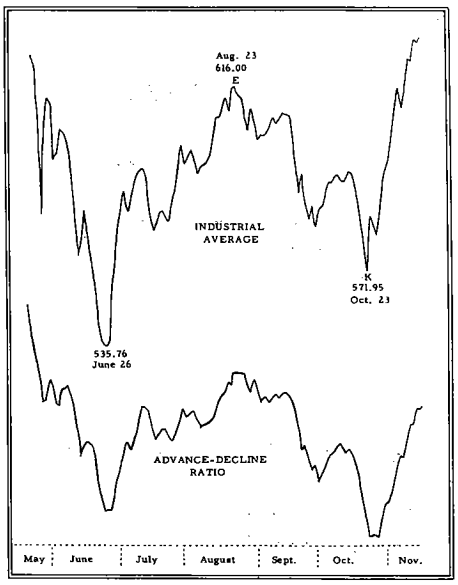
The decision to rally is, of course, now history. But it is interesting to note that as of this writing the market has put itself in a technical position exactly opposite to that which existed at the October (K) lows. As seen on the smaller chart (page 2), the Industrial Average is now well above its August, 1962 (616.00) peak, but the A-D ratio has (so far) not confirmed the outstanding performance of the Industrials.



The critical technical question now is — will the A-D ratio be able (over the foreseeable future) to confirm the upside penetration of the Industrial Average (i.e., will the A-D ratio be able to better its own August peak), or has the A-D ratio recorded an important "top" preparatory to a major decline towards or below the October lows? Obviously, if the A-D ratio is now merely "pausing" in preparation for a forthcoming upside penetration of its August peak, the current advance will in all likelihood have considerably further to go. On the other hand, if the A-D ratio now declines importantly, or persistently resists penetration of its August peak, we will have a situation suggestive of important technical weakness.

Letter 200 voiced the opinion that the market is in an "overbought" condition. This implies that the majority of issues should shortly be subject to a period of

consolidation, decline, or both. I want to stress that the rise from point K is of the most speculative and frantic nature — it is a true market rarity. As a point of interest, the incipient "head-and shoulders" formation in the Industrial Average (left shoulder at A, head at E, right shoulder at J) is now assuming the pattern of a potential broadening formation, the five reversal points being A-B-E-K and a point between L and the rising trendline which passes through A and E. The 5th point (assuming it is reached) comes at about the 670 area. Broadening formations are characteristic (write Edwards and Magee) of a market "lacking intelligent sponsorship and out of control." They are among the most dangerous of all patterns to "play" (see Letter 172 for detailed discussion of broadening formations).



HOW ANALYSTS MAKE MISTAKES — or How Readers Can Learn To Be Smarter Than Writers. (The following discussion does not alter my overall long-term view of the market, as outlined in Letter 200).

It is no laughing matter to have missed a rise of the proportions of the recent move from K (see chart, page 1). I have been mulling over the advance which began on October 23 ever since its inception. I believe that I should have "caught" it. Moreover, this is all the more exasperating since I had been writing about just such a possibility (i.e., a 1930-type rise) ever since Letter 184.

How could the rise have been foreseen? The following is written for my own edification — as well as for the edification of readers who will, no doubt, live to see the same sequence occur again some day.

(1) I had written about the "baby bull market" recoveries which have followed all crashes since 1929. I had stated that the 43% June to August recovery (Industrials 535.76 to 616.00) was subnormal in extent. The possibility of a full recovery should have been more prominent in my thinking. When the Industrial Average dropped below point H (to K) on the heels of the Cuban news, I felt that the price structure was breaking down. It seemed to me that if a new recovery was going to take place, it should have taken place after J — but that the H level should have held.

Anyone who thinks that the recent explosive rise stemmed from the repercussions of the Cuban Crisis is (to my mind) far, far off the road. I am convinced that the rise was coming, and that it would have materialized regardless of Cuba, Khrushchev, or anyone else. It is probably true that the Cuban bombshell drove Industrials below point K, but this move represented nothing more than a final "shakeout." Had the news of Cuba not hit the market, it is probable that Industrials might have held above H — in which case the rally would merely have started a few days earlier.

(2) During the January-June, 1962 collapse, a tremendous amount of shorting, odd-lot shorting and selling took place. Measurements which normally indicate "oversold" market conditions proved absolutely worthless as the market plunged lower during March to June, 1962. In the 1930's Robert Rhea ran a little advertisement in Barron's which bore the arresting title: "The Story is in the Averages." The averages were indeed telling the story during the first part of 1962. Despite record totals of odd-lot shorts and tremendous downside compression in breadth, the Averages and the general market continued to plunge. In other words, the downside action was unabated despite all the "abnormal bearishness." As long as such a situation prevails, the shorts (regardless of their number) are on the right side of the market.

(3) Following the June 26, 1962 post-crash low, the first rally took place. This was not a difficult one to foresee, and these Letters suggested trading commitments (Letter 187 — July 13). On August 24 (Letter 191) I recommended that earlier trading commitments be sold. During the ensuing decline which began August 23, 72% of the June-August Industrial advance was erased. During the decline bearishness again became rampant, odd-lot shorting rose sharply, and the total short interest on the N. Y. S. E. climbed to over 6 million shares.

Letter 198 (October 24) drew attention to the collapse of Barron's Low-Price Stock Index, the new bear market lows on the advance-decline ratios of both exchanges and the new low on the Rail Average. That Letter contained one sentence which (in retrospect) should have been printed in bold-faced type: "Nevertheless, according to Dow's classic Theory, it will take an Industrial penetration of the June (535.76) low to reconfirm the existence of the primary bear market."

In other words, in the face of all the bearishness, in the face of a collapse in most of the major indicators and in the face of the fear selling brought in by the Cuban news, the Industrial Average was stubbornly refusing to break to new bear market lows. At point H (see chart on page 1) the Rail Average fell to new bear market lows, but Industrials refused to confirm this low. Then at K, Industrials broke below their H level (but not to new bear market lows) while Rails refused to penetrate their preceding H level. This performance suggested remarkable resistance by Industrials and gathering resistance by Rails. The writer was put on his guard by the aforementioned action and was prompted to close Letter 198 with the following paragraph: "Recent Letters have listed many stocks for shorting. In the majority of cases, these stocks are now showing fair to

sizable profits. If you have not put out shorts by this time, it appears to me that you would be 'chasing them' at this juncture. Subscribers should try to reduce their bearishness as a move gets underway. Short profits should always be protected with mental buy orders."

(4) Chalk this writer down for the following major error: When, in the face of the collapse of the A-D ratio, the new low in the Rail Average (and the panic selling which accompanied the Cuban news), the Industrial Average would not confirm by breaking to new lows (below 535.76), I should have suggested covering all shorts as a precautionary measure. Furthermore, when the minor upward zig-zags (k-2-3-4, chart on page 1) were formed in both Averages, I should have recommended trading purchases with the stipulation that such purchases be sold if the two Averages turned down and broke below the K levels.

What stocks should have been bought? The strongest stocks in the D-J Industrial Average! The Industrial Average was the indicator which refused to confirm the bearish indications of the A-D ratio and the Rail Average. Common sense dictated that the stocks in the Industrial Average would lead on any rise. They did just that.

(5) Moral: When, within a major price decline, a great deal of bearishness is generated, disregard that bearishness as long as the two Averages continue to break to successive new lows. BUT — when that bearishness continues (regardless of bad news, pessimistic views, or preconceived notions), and one or the other Average resists further decline, watch for a reversal. If an upward zig-zag then develops in both Averages (following the nonconfirmation), cover shorts and perhaps take a position on the long side. The odds are better than 50-50 that a good rally will materialize.

(6) Conclusion: In Letter 199 (three days after the minor K-2-3-4 upward zig-zags were completed) I wrote: "Nevertheless, it should be born in mind that a persistent refusal by one Average (in this case Industrials) to confirm the indications of the other can result in a secondary reversal — and, on occasion, a primary reversal."

In the light of my own experience, I feel that I should have been much firmer about the possibility or probability of a reversal at point K. When the Industrial Averaged refused to break to new bear market lows, and certainly when the little K-2-3-4 structures were formed, I should have been stronger about (a) the probability of some kind of reversal and (b) the possibility of a violent rise. In the final analysis, "the story was in the Averages". If this same story repeats itself (and I am certain that it will), my hope is that if this writer is stupid enough to miss it again — then most subscribers will see it.

VALUES AT CRASH BOTTOMS Letter 200 contained numerous technical comparisons between the 1962 price pattern and those of preceding crash periods. Last week a subscriber wrote to ask about "values at the other crash lows as compared to values at the June, 1962 lows." Since by definition a bear market tends (eventually) to take stocks to or below true values, this subscriber then asks: "What were the value justifications for buying stocks at the June or October, 1962 lows versus the situation at other collapse-bottoms?"

This is a good question, and it points up my reason for insisting that any purchases in this market be considered trading commitments — not long-term investments.

At the September, 1929 peak, the average yield on the D-J Industrial Average was 3.3%. The crash took Industrials to a low of 198 (two months later) in November, at which time the average Industrial yield had risen to 5.2%.

At the March, 1937 peak, average Industrial yields were 3.7%. At the November, 1937 crash-bottom (eight months later) average Industrial yields had risen to 6.9%.

At the May, 1946 peak, the average Industrial yields were 3.3%. At the August, 1946 crash-bottom (three months later) average yields had expanded to 4.2%.

The preceding statistics suggest that at the crash bottoms of 1929 and 1937, average Industrial yields had increased to the point where there was some justification (forgetting all Dow Theory gauges such as timing, phases, volume implications) for buying high-grade stocks on the basis of average yield or return to the investor. At the 1946 crash bottom, yields (4.2%) had increased but were hardly in the "attractive" catagory.

Referring to the present, in December, 1961, average Industrial yields were 3.1%, and during the week of June 26, 1962 (six months later — at the lows) average yields had risen to the 4.1% level. This means that in the current affair, the lows provided considerably less attractive values than did the comparable 1929 and 1937 crash-lows. At 4.1%, the average yields of June, 1962, closely matched those of August, 1946. It is interesting to note that the 1946 crash erased 23% of the value of the Industrial Average against a closely comparable 27% Industrial loss in 1962.

The 1946-49 period was remarkable in that average yields rose steadily from 4.1% in August, 1946 to 6.8% in June, 1949 — while the Industrial Average fluctuated between 193 (the 1948 high) and 161 (the 1949 low). During this period, values

increased because dividends were raised. Yet is was not until mid-1949 that the great bull market actually started. Strangely, the technical situation simply was not conducive to the formation of a major bull market (regardless of increasing values) until 1949 (see Letter 200).

During 1929-32 (and during the great majority of bear markets) higher yields were brought about through the mechanism of falling stock prices. The 89% drop in the Industrial Average between 1929 and 1932 raised average Industrial yields from 3.3% to 10.3%.

CONCLUSION: It takes a long period of informed distribution to produce a market which is (technically) weak enough to crash. Following a major crash, it takes an extended period of accumulation before a new primary bull market can develop. Such accumulation generally occurs during a period of attractive values (and these values can be gauged by average yields on the Industrial Average). Historically, important long-term accumulation takes place in the 6% or higher area of average yields.

LATE NOTES (Written Tuesday, November 20, noon N.Y. time) Despite the obvious force of the current rise, I consider it to be the most dangerous type of move. Many stocks which rallied during June to August have not participated in the October - November advance while others (mainly "blue-chips") have been the climbers over the last month. "Power moves" of this kind often stop as quickly as they started, but more often than not they will then work sideways (sometimes for months) rather than enter into violent corrections.

In the space of a few weeks almost every analyst and service in the nation has turned bullish, and many highly-regarded observers are now talking about "another 1958" and "a rise to or above the old highs." Readers know that I felt strongly about the possibility of a collapse in early 1962, and the subsequent crash found me without any stocks. I have little feeling for the "explosion" which is now being predicted, however, and if I enter the market at all it will be with token commitments. My personal guess is that the forthcoming action will be frustrating to bulls and bears alike.

STOCKS. Of 346 representative stocks which are watched with particular care at this office, 126 or 36% are now holding above their moving average. This is a sizable jump over the past few weeks but still well below the 50% mark.

A study of hundreds of individual stock charts makes clear the completely erratic and dangerous nature of the rise. For instance, during the week of October 23, 457 stocks (or about one-third of the listed issues) broke to new lows. Subsequently, many of these issues have simply rallied from no base of accumulation whatsoever (i.e., Rubbers and Steels). A great many stocks formed head-and-shoulder tops during the July to September period; the support was broken during October; and the stocks then simply reversed and rallied back into supply (often on sharply contracting volume).

In other words (and this may sound absurd to market neophytes) the best that this writer can say of the action since October 23 is that many stocks have rallied and rallied sharply. That is not enough for me, but it does not mean that stocks cannot continue to do more of the same.

For those who feel that "insurance" against a further substantial rise is warranted, I have looked over hundreds of stocks and have come up with the following issues which look considerably stronger than the market: Avco, Westinghouse, Burlington, American Cyamimid, Dow Chem., Southern R.R., Distillers-Corp. Seagram. United Aircraft (shown below) shows excellent relative strength and has reversed to the upside via a large head-and-shoulders base.

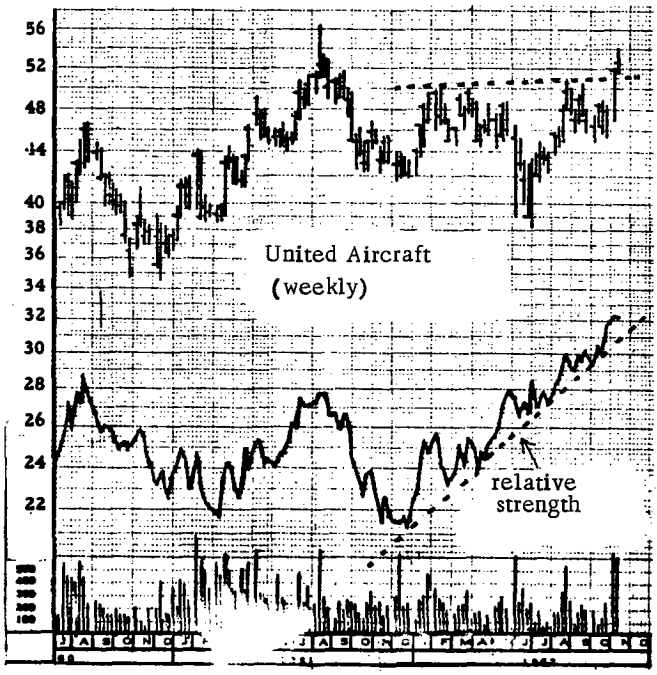


Chart of United Aircraft courtest of Traders Research, P.O. Box 2466, St. Louis 16, Missouri.

NOTICE If everything goes according to plan, I should have an important announcement (in Letter 202 or 203) for the many subscribers who have recently written in asking for historical data on the advance-decline ratio.